[JOINT COMMITTEE PRINT]

ANALYSIS OF PROPOSALS
RELATING TO
BROADENING THE BASE AND LOWERING THE RATES OF THE INCOME TAX

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INTRODUCTION

This pamphlet has been prepared by the staff of the Joint Committee on Taxation in connection with the hearings scheduled for September 28–30, 1982, by the Senate Finance Committee on lowering tax rates and broadening the base of the income tax. Part I of the pamphlet discusses the general objectives of comprehensive tax reform. Part II describes the basic characteristics of the base-broadening and rate reduction proposals. Part III analyzes some of the important issues that arise in considering major modifications to the income tax. Part IV deals with the problem of making a transition from the present system to a new system. An appendix summarizes the principal bills introduced in the 97th Congress that lower tax rates and significantly broaden the income tax base.

I. OBJECTIVES OF COMPREHENSIVE TAX REFORM PROPOSALS

Several criteria are commonly used when evaluating tax proposals, including equity, efficiency, and simplicity. Individuals often agree that the revenue which is raised by the tax system should be collected in a manner which is as fair as possible, which produces as little unintended distortion in the economy as possible, and which is as simple to administer and understand as possible. In addition, certain provisions of the tax system have been enacted to encourage specific activities which Congress has felt should be promoted. The questions of equity, efficiency, simplicity, and the encouragement of specific activities are central to the discussion of whether the present tax system should be changed by enacting one of the comprehensive tax proposals presently being discussed.

A. Equity

Horizontal equity and ability to pay taxes

A common assertion is that taxes, other than user fees collected from beneficiaries of specific programs, should be collected in accordance with a taxpayer's ability to pay taxes. Thus, taxpayers with equal ability to pay taxes should pay equal amounts of tax and, correspondingly, any taxpayer with a greater ability to pay should pay more tax. This concept is sometimes called horizontal equity. An additional dimension of equity, sometimes known as vertical equity, is the actual amount by which the tax liability of the taxpayer with the higher ability to pay exceeds that of the other taxpayer.

Income as a measure of ability-to-pay

To apply concepts of equity to the design of a tax system, it is necessary to measure each taxpayer's ability to pay taxes. In the United States, there is a tradition that a taxpayer's income is a valid measure of his or her ability to pay taxes. In this context, income is defined as the ability to provide oneself with goods and services, other than those goods and services which are necessary to earn the income. Thus, for this purpose, income is generally measured by subtracting from the sum of the gross receipts and appreciation in asset value of a taxpayer the amounts spent on goods or services which are costs of generating those gross receipts and that appreciation.

Although there are many problems obtaining all the information necessary to produce an accurate measure of income (some of the most important problems are discussed in the third part of this pamphlet), income is a commonly accepted measure of ability to pay taxes. It is often asserted that individuals with a relatively high ability to purchase goods and services which satisfy needs for private consumption also have a relatively high ability to purchase those goods and services which provide for public consumption needs, i.e., goods and

services provided by the government. If it is then agreed that those with a relatively high ability to purchase these goods and services should also be required to make a relatively high contribution toward defraying their cost, then it follows that the revenues necessary to pay for government spending should be raised by an income tax.

On the other hand, several arguments may be put forth as to why income should not be relied on as the basic index of ability to pay taxes. First, some assert that actual consumption of goods and services, not potential consumption (i.e., income), is a fairer basis for taxation. This is consistent with the belief that taxation should be based on the actual satisfaction derived from goods and services, rather than the ability to purchase them, and actual satisfaction may be more closely related to expenditures for goods and services than to income.

Second, it can be argued that income may be misleading as a singie index of ability to pay taxes because no account is taken of the time and effort expended on earning that income. Many would agree, for example, that someone who works 20 hours per week to earn a given amount of income should pay more tax than someone who works 40 hours per week to earn the same amount. This is because the former taxpayer has greater leisure time to enjoy the available goods and services and because one's leisure is itself valuable. Similarly, someone who works at a less pleasant job should pay less than someone with the same income who works in a more pleasant environment. Yet, under a tax system in which tax liability is based solely on income, no account is taken of these differences, and it would be extremely difficult to design a tax system that took these and similar problems into account.

A third problem is disagreement over what expenses should be subtracted from gross receipts as a cost of earning income. For example, questions have arisen about the extent to which business meals and entertainment should be deductible, and it can be argued that medical expenses should be deducted from the amount subject to tax because these expenses are the cost of maintaining health, which is necessary to earn income.

Vertical equity

In spite of these problems, in the U.S. income is commonly accepted as a basis for taxation. Thus, the horizontal equity concept requires that taxpayers with equal incomes should have equal tax liabilities. Vertical equity is much more subjective since it involves the comparison of ability to pay for taxpayers with different amounts of resources. Since there is no widely accepted yardstick for making these comparisons, the degree to which tax liability should vary with income is a value judgment.

The concept of progressivity is often discussed in this context. A progessive tax is one for which the ratio of tax liability to the tax base (e.g., income) rises as the tax base rises. Many argue that this is appropriate. On the other hand, others contend that the ratio of taxes to income should be constant (a proportional tax system) or should decline as income rises (a regressive system).

One argument for progressivity is that, if people examined the vertical equity question from the point of view of the very beginning of their lives, when they did not know exactly where they would end

up in the income distribution, they would be willing to agree to laws under which government would mitigate, to some extent, whatever inequalities emerged from a market economy. Progressivity is attacked, however, by those who view a taxpayer's income as essentially the fruit of his own labor and resources. Under this view, the government should have very little role in equalizing the amounts which individuals are left with after taxes, since individuals are entitled to whatever income arises from their own labor or property. This view is, in turn, contested by those who contend that labor and property have value only because society establishes laws and regulations which allow each individual to engage in economic activity with relatively little interference from others. To be sustained, these laws and regulations must be accepted even by those who are relatively unsuccessful. Thus, because society establishes the framework which allows labor and property to be valuable resources, it can also establish a progressive tax system and other mechanisms to achieve an equitable distribution of income.

In sum, although equity is an integral part of tax policy, it involves subjective judgments over which there is likely to be considerable disagreement.

B. Efficiency

Another widely accepted goal of tax policy is that taxes should interfere as little as possible with the incentives to engage in specific types of economic activity, except to the extent that Congress intends such effects. This goal is known as economic efficiency.

Virtually any tax which meets accepted equity criteria creates some interference with economic incentives. In order to have no such effect, a tax would have to be determined on the basis of some characteristic over which an individual has no control. For example, a head tax equal to a specified, constant amount per person would have no incentive effects, since it could not be avoided, but it also would be regarded by many as extremely unfair. On the other hand, a tax which varies with income creates a disincentive for earning income. Even taxes on consumption create disincentives for earning income since they reduce the potential amount of goods and services which may be purchased with the income earned from a given amount of property or work effort.

Similar trade-offs may exist with respect to vertical equity and efficiency. For example, it has been argued that a progressive tax system creates considerable inefficiency by encumbering additional income with the imposition of a still higher tax rates. In the extreme case, a 100-percent tax on additional income would eliminate any incentive to earn that income. Yet, from the point of view of equity, many argue that progressive tax rates are essential to establish a proper relationship between tax burdens and ability to pay. Therefore, given the notions of horizontal and vertical equity that are commonly accepted, there is frequently a conflict between the efficiency and equity goals of tax policy. Balancing these competing considerations is one of the most difficult aspects of formulating a tax system.

The concept of economic efficiency uses as a benchmark the production of goods and services which would occur in a market economy in

the absence of taxes. Economists generally regard this allocation of resources as a useful reference point because, under certain conditions, it insures that available economic resources are arrayed in such a way as to produce the highest possible amount of consumer satisfaction. Relative to this benchmark, taxes change the incentives to engage in various types of economic activity (e.g., work, investment, consumption of specific goods and services), which reduces the ability of the economy to satisfy consumer demands.

Thus, some inefficiency is inherent in virtually all taxes which are acceptable from the equity standpoint. However, a major goal of tax policy is to reduce this inefficiency to as low a level as possible.

C. Simplicity

A third goal of tax policy is simplicity. This is a serious concern for at least two basic reasons—compliance costs and the perception of equity.

First, a complicated tax system requires a large amount of resources to administer and understand. When the system has a large number of discrete provisions and mandates that many fine distinctions are to be made among types of income or expenses, a long series of complicated rules are necessary. The agency administering the system must have a large staff to formulate the rules and to insure that taxpayers calculate tax liability correctly. Taxpayers themselves must invest large amounts of time in understanding the rules so as to avoid overpaying their taxes, or alternatively, find that they are better off by paying for professional tax advice and preparation. This time and effort diverted from other activities is a source of inefficiency generated by the tax system in addition to the disincentive effects described in the previous section.

A second reason for a general preference for a simple tax system is that under a complicated system, similarly situated taxpayers may have different tax liabilities because they are not equal in their ability to understand the rules or pay for professional tax advice. This situation may undermine the perception that the tax system is horizontally equitable. Taxpayers may suspect that others are paying less tax not because they have lower ability to pay, but rather because they have better access to knowledge about the details of the system. If these feelings are widespread they may contribute to a feeling that the system is not fair.

A very simple tax system, however, may rank low from the equity and efficiency viewpoints. For example, a complete measure of income includes all fringe benefits. The failure to tax all fringes may lower the equity of the system by not imposing equal taxes on individuals with equal income; the efficiency of the system would be lowered because artificial incentives would be created for greater consumption of these benefits. However, it may be quite complex to define the rules necessary to tax certain forms of fringe benefits. Thus, as with other elements of tax policy, a balance must be struck among competing objectives.

D. Stimulating Other Activities

Some provisions of the tax law have been enacted to encourage particular activities rather than to promote the goals discussed above. For

example, when Congress enacted tax credits for energy conservation expenditures, it did so not to increase the equity, efficiency, or simplicity of the tax system, but rather to increase spending on goods which reduce energy consumption. This subsidy could have been provided through a spending program, but, instead, the tax system was chosen as the means by which the subsidy was administered.

In certain cases, there are advantages to providing subsidies through the tax system, since it provides an administrative mechanism, already in place, reaching a large majority of the American public.

At the same time, providing the subsidy through the tax system rather than some other mechanism may tend to interfere with the equity of the tax system. These subsidies result in a system in which tax liability is not made equal for taxpayers with equal ability to pay, and they change the relationship of tax liabilities for taxpayers with different levels of ability to pay. Further, such subsidies make the system more complicated, and may raise questions of efficiency. Although the provision of these subsidies through another administrative mechanism also would involve similar issues of equity, efficiency, and simplicity, taxpayers' perceptions of the workings of the entire tax system may be affected when they are administered through a tax mechanism.

II. CHARACTERISTICS OF COMPREHENSIVE TAX PROPOSALS

The Appendix to this pamphlet provides a description of the comprehensive tax proposals which have been introduced in the 97th Congress. While the details of these bills vary substantially, it is useful to categorize into five groups the changes these bills would make in the present tax system:

(1) The bills generally would expand the tax base by repealing a variety of deductions, exclusions and credits in the present system.

(2) Marginal tax rates applied to the base would be lowered substantially.

(3) The degree of steepness in rate schedule, the rate at which marginal tax rates increased with income, would be reduced.

(4) The aggregate distribution of tax burdens by income class would be altered by some of the proposals.

(5) The total amount of revenue raised by the corporate and individual income taxes would be changed by some of the proposals.

This part of the pamphlet considers some of the features of the present income tax which are relevant to these issues and contains a general discussion of them.

A. Changes in the Tax Base

All of the proposals under discussion would make substantial changes in the tax base. In all cases, significant items not now subject to tax would be included in the base.

Many of the proposals appear to adopt a relatively comprehensive definition of income as the primary basis for taxation. The designers of most of the proposals appear to have made the judgment that income is the best measure of taxpaying capacity and that taxpayers with equal income should have equal tax liability. In addition, it appears that they believe that many of the exclusions, deductions, and credits in the present system are inequitable, inefficient, or complex, or at least have decided that the benefits that these provisions may have are outweighed by the advantages of the other changes made by the bills, such as reductions in marginal tax rates.

Important background for analyzing these base-broadening proposals is provided by comparison of the amount of income actually subject to tax under the present individual income tax and the income recorded in the national income and product accounts. Table 1 presents the relationship between gross national product and taxable income in the United States in 1980.

Gross national product was more than double the estimated individual income tax base—$2.6 trillion versus $1.0 trillion. The $1.6 trillion dollar difference is composed of two parts. First, about $0.2 trillion of income items are included in the tax base but not gross national product. These include government subsidies, certain interest income, transfer payments, capital gains and taxable pensions and income of subchapter S corporations. Although not included in GNP, many would argue that these are properly includible in an income tax base. In fact, substantial additional portions of transfer payments and capital gains would be subject to tax under the proposals.

TABLE 1. RECONCILIATION OF GNP AND TAXABLE INCOME, 1980

Item	*Amount ($ billions)*
Gross national product	2,633.1
−Depreciation	−293.2
−Indirect business taxes	−213.0
−Statistical discrepancy	−3.9
+Government subsidies	+5.5
−Corporate retained earnings	−125.7
−Employer social insurance contributions	−115.3
+Net interest paid by government and consumers	+75.7
+Taxable government transfers	+21.1
−Fringe benefits excluded from AGI	−125.4
−Imputed income in GNP	−59.3
−Investment income of insurance companies and pension funds	−45.0
−Investment income of nonprofit organizations and fiduciaries	−18.8
−Differences in accounting treatment between GNP and AGI	−12.1
−Income of nonfilers and unreported income	−150.8
−Other discrepancies between GNP and AGI	−25.6
+Capital gains in AGI	+28.5
+Taxable private pensions	+29.4
+Subchapter S corporation income	+0.9
Adjusted gross income	1,606.3
−AGI on nontaxable returns	−58.9
−Medical deduction	−12.4
−Tax deduction	−67.3
−Interest deduction	−84.7
−Charitable deductions	−24.7
−Other deductions	−15.2
+Floor under itemized deductions (zero bracket amount on itemizing returns)	+87.0
−Personal exemptions	−185.6
Taxable income on taxable returns (level deficits)	1,244.5
−Deduction equivalent of tax credits (estimated)	−27.0
−Zero bracket amount	−212.8
Tax base (estimated)	1,004.7
Income tax after credits	247.5

Sources: *Survey of Current Business*, July 1982; *Statistics of Income: SOI Bulletin, Winter 1981–82;* Internal Revenue Service; and staff estimates.

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The second component of the difference between GNP and taxable income is approximately $1.8 trillion of income and deduction items which are included in GNP but not in the tax base. Much of this difference, however, would not be available for net base broadening under a revised income tax. First, approximately $0.5 trillion consists of depreciation and indirect business taxes, which may be considered as costs of earning income. (However, some of the bills described in the appendix appear to deny deductions for these items.) Second, $0.1 trillion of income is not reported; subjecting this amount to tax would depend on compliance measures rather than changes in the statutory tax base. Third, corporate retained earnings were approximately $0.1 trillion. This amount already is subject to tax at the corporate level, and thus a substantial portion of this may not be available for broadening the combined base of the corporate and individual taxes. Fourth, the $0.4 to $0.5 trillion accounted for by the zero bracket amount, personal exemptions, adjusted gross income on nontaxable returns, and income of nonfilers whose income is below the filing requirement is most usefully thought of as part of the rate structure. (Equity considerations lead the designers of all these proposals to exempt some amount of income from tax, using either a zero bracket amount, personal exemptions, tax credits or a combination of these approaches.) The total of these four amounts generally not available for base broadening is approximately $1.2 trillion. Thus, of the $1.8 trillion of items not included in the tax base under the present system, about $0.6 trillion could realistically be included in the base of a comprehensive tax on net income. This consists of about $0.4 trillion of fringe benefits, investment income of pension plans and nonprofit organizations, and other items not included in adjusted gross income, and about $0.2 trillion of itemized deductions and tax credits. If these items had been included in taxable income in 1980, the tax base would have been approximately 60 percent larger.

The proposals summarized in the appendix broaden the tax base considerably by increasing the amounts of capital gains, transfer payments, fringe benefits, investment income and other income items included in the tax base and reducing allowable deductions and credits. At this time, however, a quantitative analysis of the extent of this base broadening for each proposal is not available.

B. Lowering Marginal Tax Rates

In all of the proposals, marginal tax rates are substantially reduced. This reduction appears to be motivated by efficiency and equity considerations.

Efficiency

Many economists would agree that high marginal tax rates can cause considerable economic inefficiency, both by interfering with the incentives for work and saving, and by magnifying the effects caused by differences between the tax base which may be chosen purely for efficiency reasons and the base which actually is implemented in the law.

An individual's marginal tax rate is the rate applicable to the last or to the next dollar income received. If an individual is subject to a 25-percent marginal rate, then the return to additional work effort and saving is reduced by 25 percent. For example, if this individual is considering working on an overtime assignment which pays $40, then the after-tax reward to this work effort is $30. A higher marginal tax rate would reduce the return to this work effort even further, affecting the incentive to undertake the assignment. A similar point may be made with respect to investment decisions. If the individual with a 25-percent marginal rate invests in a security with a 10-percent return, the after-tax return would be 7.5 percent. Thus, the marginal tax rate affects the incentive to save rather than use the same resources for current consumption. The same reasoning may be used to show that marginal tax rates also influence the incentives to engage in activities which are heavily taxed versus those which are lightly taxed. With high marginal rates, for example, there is more incentive to invest in lightly taxed investments or to take jobs in which a high proportion of compensation is in the form of non-taxable fringe benefits than would be the case with low marginal rates.

Effect on labor supply

The effect of changes in marginal tax rates in distorting incentives is sometimes referred to as the "substitution effect." Most of the studies which have been performed on the effect of after-tax wage rates on work effort have found that the substitution effect of after-tax wage changes in hours worked is quite small for husbands but rather large for wives, especially wives with children. Since the substitution effect is measured by holding after-tax income constant, this is the proper measure of the incentive effect of a marginal rate reduction, as opposed to the "income" effects which would occur because of the income increase attributable to any tax reduction. This empirical finding is confirmed in one of the most recent and sophisticated studies,[1] except that a significant substitution effect is found for husbands, as well as wives. Thus, these studies indicate that if marginal tax rates were lowered, holding other factors (including after-tax income) constant, some individuals would be willing to work a larger number of hours. This could be manifested as greater willingness to work full-time instead of part-time, greater acceptance of overtime assignments, less absenteeism, and a larger number of individuals in the labor force.[2]

It should also be noted that there are several other possible impacts of marginal tax rates on work-related activities. First, it has been argued that reduction in marginal tax rates could improve compliance with the income tax, although there is little evidence which bears directly on this question. Second, it has been argued that high marginal tax rates have induced employees to demand a larger portion of their compensation in the form of tax-free fringe benefits, such as

[1] Jerry A. Hausman, "Labor Supply," in Henry J. Aaron and Joseph A. Pechman, eds., *How Taxes Affect Economic Behavior*, Brookings Institution, 1981.

[2] It should be noted that a tax proposal which raised after-tax income could have offsetting "income" effects because some individuals would respond to their additional income by taking more leisure time. Thus, the evidence of a significant substitution effect does not mean that a tax cut would increase labor supply, only that a cut in marginal tax rates offset by other changes in after-tax income would do so.

health insurance, than would be the case with lower marginal rates, and this substitution of fringe benefits for cash may reduce the efficiency with which the economy satisfies employees' needs. To the extent that such effects exist, they would be lessened if marginal tax rates were lowered.

Effect of marginal tax rates on saving

If an individual saves a dollar rather than spending it on current consumption, he or she generally will be able to have in excess of one dollar available for consumption in a future period. The amount of this excess depends on the return available for funds saved and on the marginal tax rate applicable to this return. The quantity of consumer goods which can be purchased in the future with a given amount of money will depend on the rate of inflation. Thus, the after-tax return (adjusted for inflation) determines the extra future consumption that a person can have by saving and thus sacrificing one dollar of current consumption. The lower the after-tax return, the more attractive is the option to consume now rather than save. As an important determinant of the after-tax return, the marginal tax rate is likely to affect this choice.

As in the above analysis of work effort, it is important to distinguish between the income and substitution effects of marginal tax rate changes on the choice between current and future consumption. Any tax reduction, including a reduction in marginal rates, will increase after-tax income and thus generally will lead to an increase in both current and future consumption. However, as discussed above, marginal tax rate reductions also would have incentive, or substitution, effects, because they change the rate at which the taxpayer can trade off between current and future consumption. This discussion emphasizes the substitution effects, which are unique to marginal tax rate reductions and which measure the economic inefficiency created by taxes.

Three distinct sources of concern with high marginal tax rates have been cited by economists who have analyzed the effects of the income tax on current and future consumption. The first concern is the effect of the marginal tax rates on individuals' incentives to consume in current rather than future periods; the second is the effect of marginal tax rates on aggregate saving, investment, and productivity; and the third involves the effect of the tax system on the composition of saving as a result of its effect on incentives to invest in lightly taxed versus heavily taxed activities and its incentive to borrow—the deduction for non-business interest.

The fact that the marginal tax rates implicit in the current income tax discourage future consumption creates a distortion (relative to a tax system with a marginal rate of zero, such as a *per capita* head tax). The importance of this distortion depends on the responsiveness of future consumption to a change in the after-tax rate of return on saving, holding income constant. Empirical studies of this sensitivity are much less numerous than those of labor supply response. The methodological difficulties of studying the responsiveness of consumption to the rate of return are greater because the expected real return (not of expected

inflation) must be measured and because the statistical analysis must be performed using time series of observations on total U.S. income and consumption. This methodology requires the assumption that the quantitative relationships among the variables have been unchanged for a long period of time. In spite of these methodological problems, empirical studies do indicate that individuals' plans for future consumption are sensitive to the after-tax rate of return. The marginal tax rate on capital income also may affect the choice between labor and leisure, as well as the choice between present and future consumption. For example, a greater after-tax rate of return may make it more attractive for individuals to work for the purpose of increasing their consumption in retirement years. However, this sort of effect has not been firmly substantiated in empirical research.

The second major concern which has been raised concerning the effect of marginal tax rates on capital income has been their effect on aggregate savings and, thus, investment and productivity. For a variety of reasons, however, the link between aggregate investment and the marginal tax rates in the individual income tax is very uncertain. First, investment may be affected much more directly by other factors, such as the tax treatment of depreciation allowances. Second, the effect of income tax changes on private saving could be offset to the extent that there is a revenue loss, which leads to less government saving. Finally, even though it is likely that a higher after-tax return may increase future consumption, it is not clear, as a theoretical matter that personal savings would increase simultaneously. This is the case because a higher return on savings actually lowers the amount which an individual needs to save in the current period in order to achieve any future consumption goal. Personal saving would increase in response to an increase in the after-tax rate of return only if desired future consumption increases sufficiently to offset this effect. Whether this is, in fact, the case can be determined only by empirical studies. Although these studies are extremely difficult to perform for the reasons discussed above, there is some indication that future consumption may be stimulated sufficiently by increasing the after-tax return that total personal saving may increase modestly in response to such a change.

The income tax also influences decisions about the particular forms in which taxpayers do their saving, which affects the allocation of capital in the economy. The first concern is that the income tax imposes heavier tax rates on some activities than others (e.g., tax shelters, owner-occupied housing, and precious metals). This provides an incentive to shift from the heavily taxed activities, which may be more productive, to lightly taxed activities. The size of this incentive depends on the marginal tax rate. Thus, it is argued, reducing the marginal tax rate may encourage individuals to shift from less productive to more productive forms of saving. The second concern relates to the present law deduction for non-business interest. Since this provision is, in effect, an encouragement for borrowing, i.e., dissaving, it is argued that reducing marginal tax rates could encourage saving by reducing the incentive to borrow. Finally, it is argued that because the income from assets subject to capital gains treatment is taxed only

when the assets are sold, high marginal tax rates discourage sales and prevent these assets from being employed in their most efficient uses. Thus, lower marginal income tax rates could increase efficiency by reducing this "lock-in" effect.

The bills discussed here tend to take several approaches to improving saving incentives. All of the bills attempt to achieve greater uniformity in the tax treatment of saving and income from capital by reducing or eliminating preferential treatment for certain types of saving relative to others. Also, the bills reduce marginal tax rates, which reduces the adverse impact of whatever distortions remain. Some of the bills, however, go farther than this and attempt to structure a system in which the effective tax rate on saving is zero. (See S. 2147 and H.R. 6628).

Equity

From an equity perspective, reducing marginal tax rates also may be viewed as desirable. Many argue that it is unfair for a high portion of each additional dollar of income earned by an individual to be absorbed as increased tax liability. In passing the Economic Recovery Tax Act of 1981, Congress lowered the highest marginal rate in the tax schedules from 70 percent to 50 percent. Much of the discussion of this change involved the belief that a marginal tax rate as high as 70 percent caused undue interference with the incentives for efficient economic performance. However, another important source of support for this reduction was the feeling that it was unfair for the tax system to claim more than half of each additional dollar earned by taxpayers. Presumably, this indicates that one accepted equity objective of tax policy is to keep marginal tax rates below some threshold level.

C. Reducing the Progressivity of the Rate Schedules

The authors of the proposals appear to believe that it is desirable to reduce significantly the number of tax brackets in the rate schedules and to reduce the difference between the bottom and top rates of the income tax. Several of the proposals have one flat tax rate that applies to all income not exempt from taxation.

It is important to emphasize that the issue of the degree of progressivity in the rate schedules is to a large extent independent of the broad vertical equity issue of the relative distribution of tax burdens by income class. For example, during 1981 the Ways and Means Committee considered a proposal to reduce the number of brackets in the rate schedule, to widen the first bracket so that a majority of taxpayers were subject to the same tax rate, and to increase the personal exemption and zero bracket amount to offset the rate increases imposed on the lowest income taxpayers. These revised rate schedules produced approximately the same amount of progressivity as under prior law. Thus, some flattening of the rate schedule is possible even without large changes in the distribution of the tax burden.

There are several advantages to a flat or flattened rate schedule. For example, if taxpayers are more likely to be in the same tax bracket

over a period of years, tax considerations would be less likely to influence the timing of transactions. This would reduce one of the sources of inefficiency of a progressive rate schedule. If most taxpayers faced the same tax rate, there would be less incentive to shift income to low bracket family members, which may improve the perception of equity in the system. The difference in tax treatment between married couples and single individuals would be reduced, since, in a system in which married couples may pool their income and file a joint return, this difference arises from the fact that the amount of income taxed at each rate depends on marital status. Finally, a flatter tax rate would allow a closer correspondence between amounts withheld and tax liability. In a system in which the tax rate did not depend on taxpayer's income, as is the case under the present social security payroll tax, withholding could be closer to tax liability in the vast majority of cases.[3]

It should be emphasized that although some flattening is compatible with a progressive distribution of tax burdens, that is, a system in which tax liability as a percentage of income increases as income rises, adopting a rate schedule with just one rate would impose strict limits on the degree of progressivity which could be obtained. Some progressivity could be attained by exempting some fixed amount of income from taxation for all individuals, but the pattern of progressivity in the present system (discussed below) probably could not be duplicated.

D. Changing the Distribution of Tax Burdens by Income Class

One of the central issues in analyzing an alternative proposal is the relationship of the tax burdens of taxpayers with different levels of income. Table 2 presents the average tax rate projected under present law for 1984. In preparing this table, taxpayers were sorted into categories according to their expanded income, a concept somewhat broader than the present definition of adjusted gross income. This is not a comprehensive definition of income, since it does not take account of many additional items which might be included in the tax base under alternative proposals or other possible changes in the measurements of income. In addition, it does not reflect the income and tax liability of the corporations in which individuals own shares. However, using expanded income probably provides a good indication of how progressive the system would appear if the tax base was more comprehensive.

As shown in Table 2, the present individual income tax system exhibits a substantial degree of progressivity. The average tax rate rises from a negative figure in the bottom class (owing to the refundable earned income tax credit) to about 25 percent in the highest class. The rate in the highest income class is approximately double the average tax rate.

[3] Currently there is about $50 billion of overwithholding and $30 billion of underwithholding. A change that eliminated most of the overwithholding, especially if it did not reduce the underwithholding significantly, could have major effects on budget receipts in the year it first took effect unless it were phased in.

TABLE 2.—AVERAGE TAX RATE ON EXPANDED INCOME UNDER PRESENT LAW, 1984 [1]

[1981 Income Levels]

Expanded income [2] (thousands)	Expanded income (millions)	Tax liability [1] 1984 (millions)	Average tax rate (tax liability divided by income, percent)
Below $5	$17,502	—$252	—1.4
$5 to $10	98,683	4,736	4.8
$10 to $15	162,784	12,531	7.7
$15 to $20	188,211	17,523	9.3
$20 to $30	416,709	44,285	10.6
$30 to $50	509,658	64,344	12.6
$50 to $100	230,678	39,111	17.0
$100 to $200	83,904	18,931	22.6
$200 above	67,540	16,731	24.8
Total	1,775,669	217,938	12.3

[1] This is preliminary data. Tax liabilities include the refundable portion of the earned income credit, but do not include changes made to individual retirement account, ACRS and other provisions by the Economic Recovery Tax Act of 1981 for which tax return data are not available.

[2] Expanded income equals adjusted gross income plus excluded capital gains and various tax preference items less investment interest to the extent of investment income.

Choosing a pattern of distribution by income class depends primarily on the vertical equity considerations discussed above. As noted before, this is largely a matter of value judgment. Some argue that the present distribution pattern should be preserved in any alternative proposal while others may believe that the present distribution is either too progressive or not progressive enough. In addition, efficiency may be a consideration in the selection of the distribution of tax burdens, because the relatively high marginal tax rates on higher income taxpayers necessary to achieve the desired distribution may result in a significant increase in the inefficiency caused by the system.

E. Achieving Specified Revenue Targets

One of the key decisions which must be made in analyzing or designing a comprehensive tax proposal is the choice of a revenue target. Clearly, if there is substantial base broadening with no changes in marginal tax rates, total revenue will be increased, and if marginal tax rates are lowered without changing the tax base, total revenue will be reduced. Several of the proposals appear to be designed so that the new combination of tax rates and tax base would produce approximately the same revenue as is expected under present law for either 1983 or 1984. However, if a judgment is made that this level is either too low or too high, base broadening and tax rate decisions can be adjusted accordingly.

F. Conclusion

Each of the comprehensive tax proposals under discussion would make changes in at least several of the five areas discussed above. It certainly would be possible to achieve base broadening by itself, although this would change the total revenue raised and the pattern of distribution by income class. Similarly, a proposal could be designed to reduce progressivity in the rate schedules while leaving the tax base, the distribution by income class, and total revenue unchanged. Marginal rates could be reduced or increased, making no changes in the tax base, but total revenue obviously would change. Even though the five areas may be logically distinct, substantial changes in any one of these areas appears to bring into consideration other objectives. The balance among these objectives depends on the equity, efficiency, simplicity, and other tax policy consideration discussed in the first part of the pamphlet.

III. ISSUES IN DESIGNING THE TAX BASE

A. Overview

One definition of a person's income is the amount he could potentially consume over a period of time without reducing his wealth. Under this definition, income during a year would equal the person's actual consumption in the year plus the increase in his wealth (i.e., his savings) between the beginning and the end of the year. This, in turn, would equal the sum of wages, interest, dividends and other receipts, minus costs incurred in earning income, plus any appreciation, realized or unrealized, in the value of the person's wealth.

The present income tax base differs from this theoretical "accretion" concept of income in a number of respects. These can be divided into ways in which the basic tax structure fails to correspond to a pure income tax (structural tax issues) and specific tax provisions which are intended to provide incentives for taxpayers to engage in particular activities or to provide relief for particular types of taxpayers (tax expenditures).

B. Structural Tax Issues

Five of the principal structural income tax issues are the following:

(1) The definition of income from capital and the treatment of borrowing during periods of inflation.

(2) The taxation of corporate-source income, including the double taxation of dividends and the treatment of retained earnings.

(3) The treatment of noncash income.

(4) The treatment of unrealized income.

(5) Whether a tax on consumer expenditures would be more appropriate than an income tax.

This section of the pamphlet discusses these five structural issues.

Indexing the definition of income for inflation

Inflation creates a problem for an income tax because it increases the difficulty of defining taxable income from capital and of properly treating borrowing. A proper definition is necessary if ability to pay is judged to be measured by income and if efficiency considerations call for equal tax rates on income from various activities. This problem is most easily seen by considering a case in which a person buys an asset for $50,000, holds it for a period during which the general price level doubles, and sells that asset for $100,000. In reality, the taxpayer has experienced no real increase in his wealth and has no income from the sale of the house; the purchasing power sacrificed in order to buy the house is exactly equal to the purchasing power represented by the sale of the house. However, under present law, the taxpayer must report a long-term capital gain of $50,000, forty percent of which is included in adjusted gross income.

A similar problem arises in measuring depreciation. In theory, depreciation should be a measure of the real loss of value of an asset during a time period. If a taxpayer buys a building for $50,000, he is presently able to claim cost recovery deductions amounting to $50,000 over a 15-year period. However, if inflation occurs during that period, the purchasing power represented by the cumulative cost recovery deductions will be less than that sacrificed to purchase the building, and real income will not be measured exactly. The same problem arises in inventory accounting when businesses use the first-in, first-out (FIFO) method of accounting in periods of inflation, since increases in the value of inventory from inflation are treated as taxable income even though the increase does not result in any real increase in asset values.

The treatment of debt in periods of inflation also fails to conform to an exact measure of real income. Inflation enables the borrower to repay debt with less valuable dollars, which represents income to the borrower that currently goes untaxed. To the extent that interest payments rise to compensate for anticipated inflation, the additional interest is deductible. Conversely, the erosion of the real value of indebtedness is a cost to the lender that he is currently unable to deduct, even though any additional interest to compensate for artifical inflation is included in taxable income.

It should be noted that the issues discussed here relating to the definition of the income tax base are entirely separate from the effect of inflation in narrowing the real width of the tax brackets and reducing the real value of the personal exemption and the other fixed dollar amounts used to determine tax liability (so-called bracket creep). For the individual income tax for years after 1984, bracket creep was largely eliminated by the indexing provisions of the Economic Recovery Tax Act of 1981.

One way to deal with these definitional problems would be to enact a full-fledged indexing program in which the definition of income from capital and the treatment of debt would be adjusted for inflation so as to achieve an accurate measure of real income. This would involve the following specific changes: (1) indexing the basis of assets by the rate of inflation for purposes both of computing gain or loss on the sale or exchange of those assets and of computing depreciation, depletion and other capital cost recovery deductions, (2) adopting a new system of inventory accounting in which costs would be indexed for inflation, (3) requiring borrowers to include in taxable income the gain that results when inflation erodes the real value of their debt, and (4) allowing lenders to deduct the loss that results when inflation erodes the real value of debt.

While the tax-writing committees have never considered such a complete indexing program, there has been serious consideration of some of its elements. In its version of the Revenue Act of 1978, the House passed an indexing adjustment to basis for capital gains and losses on corporate stock, real estate, and tangible personal property. In its version of the Tax Equity and Fiscal Responsibility Act of 1982, the Senate passed a similar provision applying to corporate stock and real estate. Indexing basis for purposes of computing depreciation deductions was discussed in the context of depreciation reform in 1980 and 1981.

There is little disagreement that a comprehensive income tax would not reach an accurate definition of income without indexing. However, full-fledged, exact indexing would add a good deal of complexity to the tax system, particularly the exact indexing adjustments for inventory accounting, borrowing and lending. Thus, in practice the choice is probably between partial indexing, limited to capital cost recovery and measurement of gain and loss, and no indexing at all. Even such a program of partial indexing would add some complexity, which might not be worth the effort at sufficiently low rates of inflation.

In place of indexing the definition of income, Congress has adopted several *ad hoc* approaches to alleviating the distortions created by inflation. The last-in, first-out (LIFO) method of inventory accounting is, in most cases, an adequate substitute for a more complicated indexed system. The exclusion for 60 percent of long-term capital gains and the ACRS method of recovering the costs of equipment and structures were both motivated, in some degree, by a desire to offset some of the distortions in income measurement caused by inflation. Furthermore, the distortion caused by the failure of the present system to make inflation adjustments for debt is reduced by the fact that the adjustments made by the borrower and lender would, to some extent, offset each other (and would be completely offsetting if the two had identical marginal tax rates).

These *ad hoc* provisions, however, are themselves deviations from what would be appropriate in a comprehensive income tax and create some inequities and distortions which, to a degree, offset the benefits they provide in reducing the distortions created by inflation. For example, an *ad hoc* adjustment, like ACRS or the 60-percent capital gains deduction, will only be accurate at a single rate of inflation, and actual inflation rates are likely to be different.

Thus, there is no entirely satisfactory solution to the problem of properly defining the tax base in periods of inflation. Any solution involves trade-offs between complexity, equity, and various kinds of distortions. Of the bills discussed in the Appendix, only S. 2147 and H.R. 6628 address the inflation problem.

Taxation of corporate income

Corporate integration

Under present law, corporate-source income is taxed at the corporate level under the corporate income tax. In addition, dividend distributions are taxed under the individual income tax, and increases in the value of corporate stock that result from earnings retention are taxed as capital gains to the shareholder. Clearly, this system does violence to the principle that all income be taxed alike. Dividends may be subject to a combined corporate and individual tax burden as high as 73 percent.[1] Retained earnings bear a 46-percent corporate tax plus a capital gains tax when the shareholder sells his stock. Corporate-source income, therefore, will generally be taxed at the same marginal tax rate as other kinds of income only in the case of corporations with zero marginal tax rates (i.e., negative taxable income or excess credits)

[1] For example, consider $100 of corporate-source income before taxes. There will generally be a corporate income tax of $46. If the remaining $54 is distributed as a dividend to a taxpayer in the 50-percent bracket, the individual income tax will be $27, for a combined tax burden of $73.

who pay out all their earnings as dividends. In other cases, corporate-source income will be taxed more or less heavily than the shareholder's ordinary income.

The present system is held responsible for creating economic inefficiency by distorting several types of business decisions. Shareholders (especially those in relative low tax brackets) have an incentive to invest in assets other than corporate stock in order to avoid double taxation. Corporations have an incentive to finance their operations with debt rather than equity because interest payments are deductible (and hence not subject to double taxation). Corporations also have an incentive to retain earnings, rather than pay out dividends, to avoid double taxation if they can ultimately distribute that money to shareholders as part of a liquidation or in connection with a takeover, the proceeds from which are usually subject to tax at capital gains rates. These distortions caused by the present system of taxing corporations have been blamed for reducing capital formation and productivity growth, preventing the allocation of capital to its most efficient uses, weakening the nation's financial structure through excessive reliance on debt, and encouraging mergers and acquisitions.

One way to treat corporate-source income would be to tax all of it, dividends and retained earnings, as if it were earned directly by shareholders. This is essentially the way subchapter S corporations are treated today. The corporate income tax could be retained as a withholding tax, for which shareholders would receive a refundable credit on their own tax returns just as they do for the present withholding taxes on wages, interest and dividends.

Unfortunately, when applied to large corporations, this type of complete integration of the corporate and individual income taxes presents serious technical problems.[2] As a result, much more attention has focused on simply reducing or eliminating the double taxation of dividends, without modifying the treatment of retained earnings. This can be done either through the dividend deduction approach or the shareholder credit approach.

The dividend deduction approach is the simplest way to eliminate double taxation of dividends. Corporations simply deduct their dividends paid in determining taxable income, in effect exempting from the corporate income tax whatever income is distributed as dividends, leaving that income to be taxed once at the shareholder level.

Under the shareholder credit approach, a shareholder would make two adjustments. First, he would "gross-up" the amount of the dividend included in gross income by the amount of the corporate tax deemed paid with respect to that income. Second, he would claim a refundable tax credit for the amount of the gross-up. If the shareholder credits with respect to a corporation's dividends exceeded the amount of corporate tax actually paid by the corporation, it would have to pay an additional tax to make up the shortfall.[3]

[2] For example, consider the situations in which two corporations own stock in each other. Neither would know how much income to report until it had heard from the other how much were the other's retained earnings. Also, there would be problems in tracing audit adjustments at the corporate level through to each of the shareholders.

[3] Under many integration proposals, the amount of the gross-up would be determined by a simple arithmetic formula whereby the shareholder would multiply his dividend by 1.85 regardless of the amount of tax the corporation actually

A number of considerations are relevant in choosing between these two approaches. The dividends-paid deduction is simpler. However, the shareholder credit provides flexibility under which, for example, the credit can be denied to tax-exempt organizations and foreign shareholders for whom there is no U.S. double taxation. This would reduce the revenue impact.

The argument for relieving the double taxation of dividends is stronger to the extent that the corporate income tax base is broadened. One problem that arises with the present relatively narrow corporate tax base is that many profitable companies have zero or low marginal tax rates because they use tax preferences, while others are subject to the top 46-percent marginal tax rate. These differences create inequities and distortions between firms, which would be exacerbated if a new deduction for dividends paid or shareholder credit were added to the system. On the other hand, the arguments for relieving the double taxation of dividends is weaker to the extent that marginal tax rates in the individual and corporate income taxes are reduced from their present levels, since the size of the distortions caused by double taxation are directly related to these marginal rates. In addition, eliminating double taxation would narrow the tax base and thus preclude further opportunities for reducing marginal rates.

Of the bills discussed in the Appendix, only S. 2147, S. 2557 and H.R. 6628 eliminate double taxation of dividends. They exclude dividends from the individual tax and, except for S. 2557, set the corporate tax rate equal to the individual tax rate.

Consistent treatment of corporations and individuals

Another structural issue is the extent to which there should be consistency between the corporate and individual income taxes, both in terms of the tax bases and the tax rates. For example, if certain tax benefits are provided to corporations and not individuals, there may be an incentive to conduct business in the corporate form and there may be inequities and competitive advantages in favor of corporate business. Also, if the corporate tax rate exceeds the top individual tax rate and there is no double taxation of dividends, corporations will have an incentive to pay out earnings as dividends up to the point where their dividends-paid deduction exhausts their taxable income. This would represent a significant change in the pattern of corporate finance.

Noncash income

Income that is received in a form other than cash often presents problems in an income tax, particularly when the cash value of the income is hard to determine. The principal types of noncash income include compensation for services paid as fringe benefits and imputed rent on owner-occupied homes and consumer durables.

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paid. This is derived as follows: Assume $100 of corporate pre-tax income. The corporate income tax is $46, leaving $54 to be distributed as a dividend. Thus, if the shareholder multiplies his dividend by 1.85, he will include the full $100 in income ($54×1.85=100). The shareholder's credit, then, would be 85 percent of the dividend, or $46. If the corporation actually paid only $40 owing to tax preferences, it would have to pay an additional tax of $6.

Fringe benefits

Present law excludes certain statutory fringe benefits from gross income and, in theory, taxes all other fringe benefits.[4] In most cases, the statutory fringes were intended by Congress as tax incentives for employers to provide compensation in particular ways, and some of the statutory provisions contain restrictions designed to carry out Congress' intent that these fringe benefits should be widely available (e.g., coverage requirements for qualified pension plans).

Although the Internal Revenue Service has prescribed consistent rules for the treatment of some fringe benefits (e.g., an employee's personal use of a company car), many other fringe benefits, while theoretically subject to tax, have been treated haphazardly because employers and the IRS have difficulty valuing these benefits and attributing them to particular employees. Thus, precisely what nonstatutory fringes are actually taxed and how they are valued may vary from one IRS district to another, and Congress has enacted riders on appropriations bills and statutory changes to block the Service's attempt to issue regulations to create greater uniformity.

Under the bills discussed here, the tax base would be broadened by repealing some of the present exclusions for fringe benefits. These benefits, including the nonstatutory fringes discussed above, may be difficult to tax for several reasons. First, how are the benefits to be valued? When an airline provides free travel to its employees, for example, what airfare is to be used in determining the employee's income, given that the passengers on the plane may be paying several different fares and that the employee may be flying on a standby basis with a lower priority than any of the regular passengers? Are the fringes to be valued based on the employer's cost (which may be very low in the case of standby travel) or the fair market value of the benefits? Second, how are benefits made available to employees as a group (such as term insurance or a tennis court) to be allocated to the individual employees?[5] In selecting the treatment of fringe benefits, the problems of inexact and complex valuations would have to be balanced against the equity and efficiency advantages of a broader tax base.

Imputed income

The two principal types of imputed income are rent on owner-occupied homes and consumer durables. In a pure income tax, a homeowner would be treated as someone in the business of renting his house. He would report as income the fair market rental on the house (imputed rent) and deduct all the costs associated with the house, including interest, taxes, utilities and depreciation. Under present law, imputed rent is not taxed, deductions are allowed for interest and taxes,

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[4] The statutory fringe benefits excluded from gross income are meals and lodging furnished for the convenience of the employer (sec. 119), educational assistance (sec. 127), prepaid legal services (sec. 120), child care (sec. 129), accident and health premiums (sec. 106), qualified pension plans (sec. 401), group-term life insurance (sec. 79), a $5,000 death benefit exclusion (sec. 101(g)), the rental value of parsonages (sec. 107), and incentive stock options (sec. 422A). However, the employer is denied a deduction for the bargain element of incentive stock options.

[5] Allocation would not be necessary in a flat-rate system with the corporate tax rate equal to the individual rate because businesses could simply be denied a deduction for certain fringe benefits, which could be excluded at the individual level.

and deductions are denied for utilities, depreciation and most other costs associated with homeownership. Thus, the tax preference for homeownership equals the imputed rent minus the nondeductible costs.[6] Consumer durables are treated the same way; no imputed rent is included, but a deduction is allowed for "consumer" interest and taxes.

Few people seriously propose taxing imputed rent on owner-occupied homes or consumer durables because valuing the rentals would be extremely complicated and there is a public policy to encourage homeownership.[7] Rather, proposals to scale back the homeowner and consumer durable preferences generally take the form of limits on, or repeal of, the mortgage or consumer interest and property tax deductions. Like most *ad hoc* approaches, however, these are not entirely free from problems of their own. Unless it were accompanied by repeal of the deduction for other nonbusiness taxes, repeal of the property tax deduction would be viewed as discriminating against those States and localities that rely disproportionately on the property tax. Limits on, or repeal of, the mortgage and consumer interest deductions tend to cut back the preference in proportion to the extent that the taxpayer finances his home or durables with debt, rather than equity, and such a nonuniform scaling back of preferences may make the system less, rather than more, equitable. Furthermore, there is a practical problem that money is fungible and that there is no real economic distinction between mortgage and consumer interest, on the one hand, and other kinds of interest that are legitimate deductions in a tax on net income, on the other.

These types of considerations lead to other proposals for reducing the distortions and inequities associated with the treatment of interest and homeownership. Some have proposed that taxpayers who rent their home receive a tax benefit designed to put them on more equal footing with homeowners. Also, it has been suggested that all interest deductions be limited to investment income. None of the bills discussed in the Appendix attempt to tax imputed rent on homes or durables; however, several repeal or limit interest and tax deductions, and S. 2817, H.R. 6944, and S. 2887 limit the nonmortgage interest deduction to investment income.

Unrealized income

Some types of income consist of increases in the value of assets prior to the time when the taxpayer actually receives the income, such as by selling or exchanging the assets. Taxing such unrealized income would present two problems: (1) in some cases, it may be difficult to value the asset in order to measure the income properly; and (2) the taxpayer may not have access to cash with which to pay his tax.

[6] This is not the way homeowner preferences are treated in the annual tax expenditure budgets published by OMB, CBO, and the Joint Committee staff. In those documents, the tax expenditure for homeownership is defined as the mortgage interest and property tax deductions, on the assumption that taxing imputed rent is not a serious possibility. Only for a house which is entirely debt-financed and whose value is equal to its purchase price will the two measures of the preference be similar.

[7] However, it should be noted that the United Kingdom taxed imputed rent on homes for over a century—from the beginning of its income tax to 1963. By that date, the property-value assessments on which the determination of imputed rent was based had been rendered obsolete by inflation, and the U.K. decided to exempt imputed rent rather than update the assessments.

Capital gains and losses is the area where unrealized income creates the most serious problems. Assuming that taxing gains and deducting losses as they accrue is ruled out because of the valuation and liquidity problems,[8] the only alternative is to tax them when realized; that is, when the asset is sold or exchanged or some other recognition event occurs. Because selling an asset is generally within the taxpayer's discretion, a tax on realized gains gives taxpayers an incentive to defer realization in order to postpone the tax.[9] This, in turn, has been a justification for providing preferential treatment for long-term capital gains, the argument being that full taxation of such gains at high ordinary rates would discourage sales of appreciated property to such an extent that it would be counterproductive. Moreover, the fact that realization of gains and losses is discretionary has been the justification for imposing *ad hoc* limits on the deductibility of capital losses.[10] Without such limits, taxpayers who own a variety of assets could realize their losses and defer their gains, thereby escaping tax despite the fact that they had substantial real income. Thus, the treatment of capital gains deviates in a number of respects from what would exist in a pure income tax.

In recent years, Congress has moved towards taxing some unrealized income, generally in areas where the valuation and liquidity problems were not significant, the income tended to be received by sophisticated taxpayers, and there was serious potential for tax avoidance. In 1969, Congress required periodic inclusions of discount income on corporate original issue discount bonds.[11] In 1981, Congress adopted a market-to-market system of accrual taxation for commodity futures contracts.

Tax treatment of saving and borrowing

A number of analysts believe that the individual income tax should be replaced by a tax on consumer spending, which could be a progressive tax just like the income tax. To convert the income tax into a tax on consumer expenditures, it would not be necessary for taxpayers to add up all their purchases of consumer goods and services. Rather, a consumption tax could be implemented through several modifications of the income tax, which make use of the arithmetical result that a person's after-tax income is either spent on consumption or saved. Thus, a consumption tax base could be implemented by starting with an income tax base, allowing taxpayers to deduct all purchases of assets during the year, all tax payments, and all repayment of debt, and requiring them to add to the tax base the proceeds from all sales of assets and from all borrowing.

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[8] Some also believe that there would be a constitutional problem with taxing unrealized gains.

[9] Furthermore, the present rule under which an heir steps up the basis of inherited assets to the fair market value for estate tax purposes means that holding onto appreciated property can ultimately result in escaping any income tax on the appreciation.

[10] Currently, individuals may deduct capital losses against capital gains and up to $3.000 of ordinary income. Unused capital losses may be carried forward. Corporations may not deduct capital losses against ordinary income. Their carryforward is limited to 5 years, but they get a 3-year carryback.

[11] In the Tax Equity and Fiscal Responsibility Act of 1982, the inclusion formula was revised and periodic inclusion was extended to noncorporate bonds and stripped coupon bonds.

Effect on incentives

Proponents of the consumption tax base argue that the income tax, by taxing income from capital, encourages taxpayers to consume their income now rather than save for future consumption and that a consumption tax would not distort this decision. Advocates of the income tax do not generally dispute this proposition but argue that the effect is not large enough to justify a change, that society can increase its saving by reducing government budget deficits and that other economic inefficiencies would be caused by the high marginal tax rates which would be necessary if saving were excluded from the tax base.

Equity

Advocates of the consumption tax also argue that such a tax would be more equitable. Consider a simple example in which two taxpayers each earn $100. One consumes his after-tax income immediately, while the other invests it at 10 percent and consumes the proceeds the next year. Under an income tax with a 50-percent rate, both taxpayers would pay $50 in the first year, but the saver would pay an additional $2.50 on his $5 of investment income in the second year. Under a consumption tax, the taxpayer who spends in the first year would pay $50 that year, while the saver would pay $55 in the second year; that is, the present value of their tax burden would be the same. (Under an income tax limited to personal service income, they both would pay $50 in the first year, so that their tax burdens would be identical in both years.) Proponents of a consumption tax argue that these two taxpayers are similarly situated because they have exactly the same opportunities over the two-year period and that it is equitable for them to pay the same tax either directly (as in an income tax on personal service income) or in present value terms (as in a consumption tax).

Critics of the consumption tax approach argue that a year-by-year comparison is more appropriate than a lifetime perspective and that, from this standpoint, the two taxpayers are only similarly situated in the first year, with the saver better off in the second year and, hence, able to pay more tax that year. They also argue that the equity argument in favor of the consumption tax hinges on treating bequests as consumption and taxing them as such when a person dies. This, however, would be a controversial aspect of any consumption tax, since the bequests would be taxed again when consumed by the heirs. Moreover, taxpayers who are consuming more than their income because they are facing hard times, like the unemployed, would fare worse under a consumption tax than under an income tax, which may not be considered a fair result. Other taxpayers whose burdens would be higher under a consumption tax would include the elderly and parents putting their children through college.

Problems with the income tax

One argument for a consumption tax is that it would moot many of the questions that make it difficult to structure an income tax. A consumption tax would require no special rules for indexing the definition of income from capital and borrowing for inflation, capital gains and losses, depreciation, inventory accounting, or unrealized income. However, some structural problems with the income tax, like the treatment of many fringe benefits and of imputed income, would remain; and

the consumption tax would create some new problems, like the treatment of gifts and bequests.

Marginal tax rates

A consumption base would be narrower than a comprehensive income base (although not necessarily narrower than the present income tax base), and higher-income people tend to save a larger percentage of their income than others. Therefore, to raise a given amount of revenue with a given degree of progressivity, the consumption base would require higher marginal tax rates than an income base. These higher rates would increase the ill effects of whatever distortions remained in the consumption tax system.

Transition issues

There would be difficulties in effecting a transition from an income tax to a consumption tax. It would be unfair, for example, to tax consumption out of wealth which had been accumulated out of after-tax income under the prior income tax. A transition rule to prevent such double taxation, however, such as allowing taxpayers to deduct the basis of assets held on the effective date of the consumption tax in order to grandfather consumption out of previously taxed income, would have a large revenue loss in the early years of the tax and would virtually exempt many wealthy people from tax for a period of years.

C. Tax Expenditure Provisions

In addition to addressing the structural problems outlined above, a thorough review of the income tax would have to confront the variety of special provisions that have been added to the law over the years to provide incentive for particular kinds of activities or to provide relief to particular kinds of taxpayers. There are about 100 such tax expnditure provisions, more than one-quarter of which have been enacted since 1976. They include exclusions for certain kinds of income, deductions for costs other than the costs of earning income, tax credits, and tax deferral provisions.

In this regard, there are several important considerations. Tax expenditures have the advantage that they can be plugged into an administrative mechanism through which the government already communicates with a large number of its citizens. Tax expenditures do not generally require separate or detailed application forms, and they are received relatively quickly. On the other hand, most tax expenditures make the tax system more complex for the taxpayer and also reduce the extent to which the public perceives the system to be equitable. In addition, if the tax expenditure takes the form of an exclusion or deduction in a system with progressive rates, it provides a higher rate of subsidy to high-income than to low-income taxpayers, a result which may be undesirable. Unless the tax expenditure is refundable, it will not be available to taxpayers with no tax liability, and if such taxpayers are corporations, they may have a purely tax-motivated incentive to merge with taxpaying units. Tax expenditures may also cause administrative problems for the agency administering the tax system, which may be required to deal with policy issues outside its normal area of expertise. Tax expenditures have also been criticized

for being, in effect, entitlement programs which are not reviewed each year as part of the appropriations process and not subject to the controls which the budget process imposes on new entitlement authority. (However, in recent years Congress has tended to put termination dates on many new tax expenditure provisions to encourage periodic review of them.)

Analysis of tax expenditures generally involves two issues. First, whether the nontax policy goal accomplished by the tax expenditure is worth the lost revenue and whatever other tax policy goals are being sacrificed must be decided. This is likely to be based on efficiency (benefit-cost), distributional, and administrative considerations similar to those discussed in the first part of this pamphlet. The second decision is whether other approaches to achieve the nontax policy goal, such as spending or regulation, would be preferable. After reviewing tax expenditure provisions as part of an overhual of the income tax, Congress could decide that the nontax policy goals of certain tax expenditures should be accomplished with spending programs, in which case not all the revenue raised by broadening the tax base would be available to finance tax rate reductions. For example, if the charitable deduction were repealed, Congress might want to enact a spending program under which the Federal Government matches private contributions to charitable organizations. Conceivably, this matching grant program would cost as much as the revenue loss from the deduction.

Most of the bills discussed in the Appendix repeal all, or most, of the tax expenditure provisions and use the resulting revenue gain to finance tax rate reductions.

IV. ISSUES IN TRANSITION TO A NEW SYSTEM

A. General Transition Issues

Hypothetically, if a comprehensive income tax bill were enacted and made effective overnight, taxpayers would experience sharp swings in after-tax income, wealth, and cashflow. Contracts and investments which were profitable under the old tax rules could be rendered unprofitable. Taxpayers who made tax-preferred investments under the old rules would experience an abrupt decline in current (after-tax) income and in wealth—the capitalized value of future income—relative to taxpayers holding ordinary investments. This reduction in taxpayer wealth might be regarded as particularly inequitable when the shelter was designed and encouraged by Congress in order to achieve certain social or economic objectives, as in the case of tax-free municipal bonds. On the other hand, windfall losses due to the elimination of abusive tax shelters would not necessarily be viewed as undesirable tax policy.

Suddn changes in taxpayers' incomes may also create a perception of inequity because taxpayers may find it diffieult to adjust their spending patterns to sudden changes in their after-tax income. This is particularly true of changes which affect low- and moderate-income taxpayers.

B. General Transition Rule Options

The goals of wealth protection and time-to-adjust can be achieved by two general types of transition rules: (1) grandfather clauses and (2) phase-in provisions. Grandfather clauses permit (or require) contracts and investments, initiated under the old tax rules, to be governed by the old law. If the grandfather clause is available on an elective basis, the taxpayer can avoid being made worse off as a result of the tax change; while if the clause requires old-law tax treatment, then some windfall gains, due to the tax law change, are also eliminated. A grandfathering provision may apply to all eligible investments or be limited to owner of the investment at the time the change in tax rules was first considered or enacted. If the clause is limited to the original owner, then taxpayers may not be protected against windfall losses if the investment is sold to another, ineligible, investor. If the investment, rather than the owner, is grandfathered, then the owner is protected against a windfall loss even if the investment is sold after the tax law change; indeed, since the grandfather clause creates a limited supply of old-law investments, original owners may reap windfall gains under such a rule. Also, if a tax change has been widely anticipated for a long time prior to enactment, asset values may reflect the likelihood of the change, and a grandfather rule may lead to windfall increases in asset values.

Phase-in provisions may be used to delay the effect of new tax rules on both existing and new investments. With respect to existing invest-

ments, a phase-in rule provides temporary and partial protection of asset values compared to an elective grandfather clause. The longer and more gradual a phase-in rule, the more similar it is to a grandfather clause. In the limit, if the new tax rules are only phased-in after existing investments are scrapped, then the phase-in provision is precisely equivalent to a grandfather clause for existing investments. However, since may investments, such as homes, last 30 years or more, very long phase-in rules would be required to effectively grandfather all existing investments. With respect to new assets, the effect of a phase-in period is primarily to slow the rate of transition, thereby allowing taxpayers adequate time to adjust. Phase-in provisions may gradually change tax laws or simply provide a grace period in advance of a major change in rules. Both a gradual phase-in and a grace period moderate wealth changes on existing assets and provide taxpayers time to adjust.

Three criteria for selecting between the alternative grandfathering and phase-in approaches are: (1) effectiveness in achieving the twin goals of moderating adverse wealth effects and providing taxpayers adequate time to adjust, (2) absence of perverse incentives for taxpayers to make non-economic, tax-motivated investments during the transition period, and (3) simplicity of transition rules. It is unlikely that any one transition rule best satisfies all three criteria, so that the choice among alternatives requires judgment about the relative importance of these objectives.

C. Specific Issues in the Transition to a Comprehensive Income Tax

This section surveys some of the specific transition problems associated with eliminating some of the major exclusions and deductions.

Exclusions.—Some of the most important exclusions in the individual income tax are the exclusions for: (1) transfer payments like social security and public assistance, (2) fringe benefits, and (3) 60 percent of capital gains. Including transfer payments in taxable income would reduce the benefit from these payments to recipients whose income exceeds the level at which people begin to pay tax. It would be possible to readjust benefit schedules to compensate for inclusion in taxable income for taxpayers with a particular marginal tax rate, but this could take Federal and State governments a period of several years. To allow for such legislation, it may be appropriate to delay the effective date of repeal of the exclusion for transfer payments or to phase it in. To the extent benefits are not readjusted for inclusion or the taxpayer's marginal tax rate is higher than the rate on which the benefit readjustment was based, current and future recipients would be adversely affected. This could create a problem, such as for people who have already retired or expect soon to retire on the basis of a certain level of tax-exempt retirement benefits (like social security). One possible response to this problem would be to grandfather retirement benefits that accrued prior to the change in the law. The drawback of grandfathering accrued retireemnt benefits is the difficulty in distinguishing retirement benefits accrued before the law change from those accruing afterward. For this reason it might

be simpler to tax a gradually rising percentage of retirement benefits. This phase-in approach would tax least the benefits of those taxpayers nearest to retirement.

Including fringe benefits in taxable income would reduce the effective salary of employees now benefiting from fringes. Taxpayers presumably would respond by substituting cash wages for some of the less desirable fringes, but this could take time (e.g., to renegotiate labor contracts). Moreover, there will be many cases in which workers have accrued fringe benefits where realization has not take place. The simplest transition rule would be to allow a grace period of one or more years in which realization of accrued fringe benefits could take place under the old tax law and taxpayers would have time to modify compensation arrangements.

Including 100 percent of capital gains in taxable income (without reducing tax rates) would reduce the value of many assets. The reduction in value would be largest for assets whose return is disproportionately in the form of capital gains (e.g., gold, discount bonds, and homes). While accrued but unrealized capital gains could be grandfathered by applying the new rules only to appreciation occurring after the effective date (a fresh start), this would require the segregation of assets acquired prior to the law change, and measurement of the market value of these assets. This approach was used when the original income tax was enacted in 1913 and when carryover of basis was enacted in 1976, but it created difficulties each time. An alternative approach would be to provide a grace period during which accrued capital gains could be realized under the present tax law. This, however, would give taxpayers an incentive to sell assets during the grace period, thereby distorting decisions. A third approach would be to retain existing law for assets owned on the effective date, but this could discourage sales of those assets. Under any of these options, the inclusion of capital gains in taxable income of future owners would lower the price at which some assets could be resold, so that some of the transition rule would eliminate the decline in wealth due to the full inclusion of capital gains. If tax rates are substantially lowered at the same time the capital gains exclusion is eliminated, the effective rate of tax on capital gains may not increase as a result of comprehensive income tax reform, which may reduce the need for transition rules; however, there still could be declines in the values of assets whose return consists disproportionately of capital gains.

Itemized deductions.—The most important itemized deductions in the individual income tax are the deductions for interest, state and local taxes paid, charitable contributions, and medical expenses.

Eliminating the deduction for mortgage interest would significantly increase the tax liability of most homeowners as well as reducing the market value of most homes. Grandfathering interest paid on existing home mortgages would protect recent homebuyers from an increase in tax liability but would not prevent the present owners of the housing stock from suffering a loss in property value. To fully protect homeowners, old-law treatment would have to be accorded to the existing stock of housing in perpetuity. The transition problems associated with housing are especially difficult because housing is extremely durable and repreesnts a large portion of taxpayer wealth. One possible transition rule would be to allow existing homeowners

to take a deduction or credit for the estimated reduction in property value due to the tax law change. While this would compensate the losers from eliminating the mortgage interest deduction, it would be difficult to estimate accurately the monetary loss. Alternatively, a phase-in could moderate the decline in home prices.

Elimination of the deduction against Federal income tax for certain kinds of State and local taxes paid would increase the tax liabilities of itemizing taxpayers who pay high State and local taxes. This would put some pressure on State and local governments to change their mix on tax revenues. Therefore, a grace period would give State legislatures time to make the appropriate adjustments.

Elimination of the charitable contribution deduction would reduce the level of charitable giving, perhaps substantially. This would reduce the revenue of organizations that rely on charitable contributions and force a reduction in their programs and outlays. A phase-in period would provide time for charitable organizations to develop alternative sources of revenues and to bring expenditure plans in line with income.

Elimination of the medical expense deduction would increase the tax liability of itemizing taxpayers whose unreimbursed medical expenses exceed 5 percent of adjusted gross income. A phase-in or grace period could be helpful to allow taxpayers time to raise their medical insurance coverage.

The number of transition problems which arise in the adoption of a new tax system are numerous and often are different for the different provisions being changed. These transition problems should be considered one-by-one comprehensive income tax bill. None of the bills discussed in the Appendix addresses transition issues, although some have delayed effective dates for the bills as a whole.

APPENDIX

DESCRIPTION OF COMPREHENSIVE INCOME TAX BILLS IN THE 97TH CONGRESS

Twelve bills (7 in the House and 5 in the Senate) have been introduced in the 97th Congress which address the issues of comprehensive income tax reform. Generally, these bills broaden the income tax base by repealing or modifying tax expenditures and lower and flatten the individual income tax rate schedule. A number of these legislative initiatives also address structural issues in the current income tax system including the marriage penalty, the treatment of saving, the effect of inflation in defining income from capital, and the relationship between the corporate and individual income taxes. These comprehensive income tax bills range along a spectrum from those with a very broad base and a low flat rate to more narrowly based taxes with moderately progressive rates. A brief description of these bills follows, proceeding from the pure flat rate to the progressive rate proposals.

Eight of the twelve comprehensive income tax reform bills are proportional tax plans. These flat-rate proposals eliminate progressivity at the upper income range, while retaining some progressivity in the lower range depending on the level of personal exemptions for taxpayers, spouses, and dependents. The reduction in progressivity is accompanied by a more uniform tax burden among taxpayers with equal incomes.

Proportional tax bills

H.R. 5513 (Rep. Crane) and S. 2200 (Sen. Helms), the "Flat Rate Tax Act of 1982," repeal all exemptions, exclusions, credits, and deductions other than a personal exemption of $2,000. A flat rate of 10 percent is imposed on gross income of individuals (including estates and trusts). The bill does not address corporate income taxation.

H.R. 6352 (Rep. Paul), the "Flat Rate Tax Act of 1982," is similar to the Helms/Crane bill except that the personal exemption is a flat $10,000 per tax return.

H.R. 6741 (Rep. Dreier), the "Flat Tax Act of 1982," is identical to the Helms/Crane bill except the individual income tax rate is 14 percent rather than 10 percent.

H.R. 4821 (Rep. Hansen), the "Tax Simplification Act," is similar to the Helms/Crane bill except that the personal exemption is kept at $1,000, the tax rate is 14 percent, and some deductions and exclusions are retained. Rep. Hansen's bill retains the exclusions for: (1) life insurance proceeds payable by reason of death and the $5,000 exclusion for employee death benefits, (2) gifts and inheritances, (3) income from the discharge of indebtednes, (4) income from the recovery of bad debts, and (5) contributions in aid of construction. It retains

all deductions in arriving at adjusted gross income except for: (1) moving expenses, (2) individual retirement accounts and certain other retirement plans, (3) two-earner couples, and (4) 60 percent of long-term capital gains. Also, the Hansen proposal retains the itemized deductions for: (1) business or investment expenses, (2) charitable contributions to churches, and (3) medical expenses in excess of 10 percent of AGI. The alimony deduction is made an itemized deduction.

H.R. 6070 (Rep. Panetta), the "Income Tax Simplification Act of 1982," broadens both the individual and corporate income tax bases and converts the personal exemption into a credit. H.R. 6070 eliminates all other tax credits and all exclusions except for gifts and inheritances. In addition, H.R. 6070 eliminates all itemized deductions except: (1) trade or business expenses, (2) losses other than from wagering, and (3) expenses for producing income. The special rules for travel expense deductions of State legislators are repealed. The computation of taxable for business income is revised to allow deductions only (1) trade or business expenses, (2) losses, (3) amortization of construction period interest and taxes, (4) contributions to black lung benefit trust funds, and (5) business startup costs. Deductions for business entertainment are repealed. Insurance companies are made subject to the general corporate tax rules. The alternative capital gains tax rate for corporations is repealed. The $1,000 personal exemption for taxpayers and dependents is converted from a deduction to a credit of $1,000 for taxpayers and a credit of $200 for dependents. The extra exemptions for age and blindness are also converted to $200 credits. (At a 19-percent tax rate, a $1,000 credit is equivalent to a $5,263 personal exemption deduction, and a $200 credit is equivalent to a $1,053 deduction.) H.R. 6070 also imposes a low graduated tax on corporate income, ranging from 3 to 15 percent.

Senator DeConcini (S. 2147) and Rep. Dannemeyer (H.R. 6628) have introduced flat-rate bills which instruct the Treasury to create a tax system based on a tax reform proposal designed by Robert Hall and Alvin Rabushka of the Hoover Institution. The bills differ only with respect to the tax rate which is "not to exceed 20 percent" in S. 2147 and is "not exceed 15 percent" in H.R. 6628. Essentially, the bills tax all income at a single flat rate. However, immediate expensing is allowed for all capital expenditures. Rules are provided to prevent double taxation of corporate-source income; that is, income is taxed either to a business or to an individual but not to both. (With a single flat rate applying to both corporations and individuals, it does not really matter where the income is taxed.) Exemptions are provided to relieve the tax burden from poor households.

Progressive rate bills

In contrast to the pure flat-rate tax bills, Senators Quayle, Bradley, and Mitchell, and Rep. Gephardt have introduced broad based tax reform bills with progressive rate schedules. These bills are designed to reap the advantages of a broader base income tax without giving up some tax rate progression.

S. 2557 (Sen. Quayle), the "SELF—Tax Plan Act of 1982," taxes individual income at a graduated rate ranging up to 25 percent, and corporate income at a flat 20 percent. It also significantly broadens

the individual and corporate income tax bases. It establishes the following principles to govern base broadening: (1) deductions shall be allowed for ordinary and necessary business expenses, (2) there should be no tax on dividends, interest or gain from the sale of a business, (3) the marriage penalty shall be eliminated, and (4) social security and other retirement benefits should not be taxed twice.

Senator Bradley (S. 2817) and Rep. Gephardt (H.R. 6944) have introduced the "Fair Tax Act of 1982." The Bradley/Gephardt bill is a progressive-broad based bill. It does not address the corporate income tax. The individual income tax is converted to a flat 14-percent normal tax on taxable income and a surtax, with rates between 6 and 14 percent, on adjusted gross income in excess of $25,000 for single persons and $40,000 for married couples. The Bradley-Gephardt bill repeals the exclusions for income earned abroad; interest on industrial development or housing bonds; interest and dividends; reinvested dividends from public utility stock; interest on life insurance saving, scholarship and fellowship income in excess of tuition; one-third of employer-provided health insurance premiums; employer-provided child care, educational assistance, group-term life insurance, and prepaid legal services; unemployment compensation; and disability pay. It repeals all nonrefundable tax credits except the foreign tax credit. It repeals the deductions for expensed intangible drilling costs, percentage depletion, amortization of reforestation expenditures and pollution control facilities, 60 percent of net long-term capital gains, second earners, expensed construction period interest and taxes, casualty and theft losses, adoption expenses, nonmortgage interest in excess of investment income, State and local taxes other than income and real property taxes, medical expenses below 10 percent of AGI, and the charitable deduction for nonitemizers. The personal exemption is increased to $1,500 for each taxpayer and $1,750 for a single head-of-household. The zero bracket amount is increased to $4,600 for married couples. The child care credit is converted into an itemized deduction. The exclusion of up to $125,000 of gain on the sale of a home by a person aged 55 or over would apply to the normal tax but not the surtax. A 14-percent tax would be imposed on the investment income of pension plans, IRAs and H.R. 10 plans. The proposal is designed to mirror the present law distribution of the income tax burden by income class.

S. 2887 (Sen. Mitchell) the "Personal Income Tax Reform Act of 1982," is identical to the Bradley/Gephardt bill except the rates are more progressive (12 percent normal tax and 8 to 24 percent surtax), the business meal deduction is repealed, and the medical expense deduction is the same as present law (i.e., excess over 5 percent of AGI is deductible).

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